North Dakota Legislative Council

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# ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - RESEARCH EXPENSE TAX CREDIT

Pursuant to North Dakota Century Code Section 54-35-26, enacted in 2015, a variety of economic development tax incentives must be reviewed by a Legislative Management interim committee once in each 6-year review cycle. The study is aimed at ensuring that economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum has been provided to assist in the review of the research expense tax credit and provides an explanation of the incentive, the perceived goals of the Legislative Assembly in creating or altering the incentive, the outcome of past reviews of the incentive, and the data and testimony required to conduct an effective analysis of the incentive.

## EXPLANATION OF THE RESEARCH EXPENSE TAX CREDIT

Section 57-38-30.5 provides for a research expense tax credit. The incentive is available to all income taxpayers and allows for a credit against state income tax liability for expenditures related to conducting qualified research in this state. The amount of the credit is equal to a percentage of qualified research expenses which exceed a defined base amount. The definitions of "qualified research expenses" and "base amount," for purposes of Section 57-38-30.5, have the same meaning as provided in Section 41 of the Internal Revenue Code [26 U.S.C. 41], with the exception that any expenses incurred for research conducted outside North Dakota are excluded. The credit is equal to 25 percent of the first $100,000 in qualified expenses that exceed the base amount and a varying percentage of any amounts exceeding the first $100,000. The percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses varies based on the year in which a taxpayer first began conducting qualified research in this state.

If qualified research in this state began before 2007, the percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses is:

- 7.5 percent for tax year 2007;
- 11 percent for tax year 2008;
- 14.5 percent for tax year 2009;
- 18 percent for tax years 2010 through 2016; and
- 8 percent for tax year 2017 and any subsequent tax years.

A taxpayer qualifying for the credit under these conditions is limited to claiming no more than $2 million in credits in any taxable year and may not apply the amount of any unused credits in any other taxable year.

If qualified research in North Dakota began on or after January 1, 2007, and before January 1, 2011, the percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses is equal to 20 percent for taxable years 2007 through 2016. If qualified research in North Dakota began on or after January 1, 2011, the percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses is 8 percent. The percentage of allowable credit on amounts exceeding the first $100,000 in excess qualified expenses also is 8 percent for any credits claimed in taxable years after 2016, regardless of when the taxpayer first began conducting qualified research in this state.

A taxpayer may elect to use an alternative, simplified method for calculating the research and experimental expenditures income tax credit, which is similar to the simplified method provided under federal tax law for calculating the federal research tax credit. Under the alternative method, the credit is equal to 17.5 percent of the first $100,000 of the alternative excess research and development for the taxable year. The percentage credit allowed on amounts exceeding the first $100,000 of the alternative excess research and development for the taxable year is 5.6 percent. Alternative excess research and development is defined in Section 57-38-30.5 as "the amount of qualified research expenses which exceeds 50 percent of the average qualified research expenses for the 3 taxable years preceding the taxable year for which the credit is being determined." If a taxpayer has zero qualified research expenses in 1 of the 3 taxable years preceding the taxable year the credit is determined, the amount of qualified research expenses for the taxable year is multiplied by 7.5 percent of the first $100,000 plus 2.4 percent of qualified research expenses for the taxable year in excess of $100,000.

For a taxpayer that began conducting qualified research in this state on or after January 1, 2007, any credit amount exceeding a taxpayer's liability may be carried back to each of the 3 preceding taxable years or carried forward to each of the 15 succeeding taxable years. A passthrough entity entitled to the credit must be considered the taxpayer for purposes of the credit and the amount of credit allowed must be determined at the passthrough entity level. A taxpayer entitled to the credit, and filing a consolidated return, may claim the credit against the aggregate North Dakota tax liability of all corporations included on the consolidated return except in the case of credits received by way of sale, transfer, or assignment.

A taxpayer certified by the Department of Commerce as a primary sector business, with annual gross revenues of less than $750,000, which did not conduct qualifying research in this state until after December 31, 2006, may elect to sell, transfer, or assign up to $100,000 of unused credits to another taxpayer. The transferor and transferee are required to jointly file information with the Tax Department, including a copy of the purchase agreement; the name, address, and taxpayer identification number of both parties; the amount of the credit being transferred; the gross proceeds received by the transferor; and the taxable years for which the credits may be claimed. Each party also is required to file a Form 500 with the Tax Department to allow the Tax Department to disclose tax information to either party for purposes of verifying the correctness of the transferred credit. This information must be filed with the Tax Department within 30 days of the parties executing a purchase agreement. The transferee must claim the credit in the year in which the purchase agreement is executed and may carry forward any unused credits to each of the 15 succeeding taxable years. The transferee may not carry unused credits back to prior tax years nor may the transferee sell, assign, or transfer the credit. The transferor must assign any gross proceeds received as a result of the credit transfer to North Dakota for purposes of taxation.

## PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE RESEARCH EXPENSE TAX CREDIT

Section 57-38-30.5, providing for a research expense tax credit, was created through the passage of House Bill No. 1645 (1987). As originally enacted, Section 57-38-30.5 provided for a corporate income tax credit equal to 8 percent of the first $1.5 million of North Dakota qualified research expenses in excess of base period research expenses, and 4 percent of any amount exceeding $1.5 million in excess research expenses. The credit allowed for the same 3-year carryback and 15-year carryforward periods that are provided in current law. The 1987 legislation was patterned after a Minnesota law that had proved to be very successful for that state. Upon a review of the legislative history pertaining to House Bill No. 1645, the perceived goal of the Legislative Assembly in creating this credit was to encourage new and existing North Dakota corporations to undertake research and development. The credit was seen as a tool to help stimulate economic development. It was estimated the research and expense credit would result in a reduction in general fund revenues of $90,000 for the 1987-89 biennium, although it was noted this amount was potentially understated as very little information was available pertaining to future corporate research activity in the state.

Section 57-38-30.5 was amended during the 1993 legislative session through the passage of Senate Bill Nos. 2222 and 2223. These bills provided for the creation of the North Dakota Limited Liability Company Act and referenced this new type of business entity within the language providing for the research expense tax credit.

The first substantial restructuring of Section 57-38-30.5 did not occur until the 2007 legislative session with the passage of House Bill Nos. 1412 and 1018. House Bill No. 1412 expanded the availability of the research expense tax credit to passthrough entities and House Bill No. 1018 allowed for individual income taxpayers to qualify for the credit. House Bill No. 1018 also broadened the scope of the research expense tax credit by allowing a taxpayer to sell, transfer, or assign up to $100,000 in unused credits and further amended the section to include substantially the same provisions as are seen in current law. The fiscal impact of expanding the availability of the credit to passthrough entities could not be determined, but the impact of expanding the credit to individuals, and increasing the available amount of the credit, resulted in an estimated reduction in general fund revenues of $2.47 million for the 2007-09 biennium. A notation provided in the fiscal note indicated this figure could increase depending on the degree by which the increased credit rate, and the new transferability feature, expanded the use of the credit. The identified goals of applying the changes provided in House Bill No. 1018 were to attract new businesses to this state to conduct research activity and retain those businesses already present.

Amendments to Section 57-38-30.5 during the 2009 legislative session generally consisted of technical corrections, including a slight modification to a defined term pursuant to the passage of House Bill No. 1086, and the elimination of a reference to the optional long-form filing method (Form ND-2) pursuant to the passage of House Bill No. 1324. The credit also was modified during the 2013 legislative session through the passage of House Bill No. 1106 and Senate Bill No. 2207. Changes made pursuant to House Bill No. 1106 streamlined the lengthy description of a passthrough entity by providing a definition of the term at the outset of the income tax chapter. More substantive changes resulted from the passage of Senate Bill No. 2207, which added an additional subsection to Section 57-38-30.5 to safeguard references made to federal definitions throughout the section from becoming ineffective should the federal research tax credit be discontinued. The credit was further modified by House Bill No. 1044 (2017), which created a uniform definition of "primary sector business" in Title 1. The most recent change resulted from House Bill No. 1111 (2019), which provided an alternative, simplified method for calculating the research and experimental expenditures income tax credit.

## PAST REVIEW OF THE RESEARCH EXPENSE TAX CREDIT

The research expense tax credit was last reviewed by the 2017-18 interim Taxation Committee. During the course of its study, the committee received information from a representative of the Tax Department regarding the number of claimants and the amounts claimed on individual and corporate income tax returns from 2007 to 2016. According to the testimony, approximately 1,800 taxpayers claimed the credit from 2007 to 2016. Individuals claimed over $4.5 million and corporations claimed over $500,000 for the research expense tax credit in the 2016 tax year. The committee received an evaluation of the credit from a representative of the Bank of North Dakota, which indicated the credit added 1,100 jobs and 1,000 individuals to the state's population at its peak and resulted in a medium-term positive economic and demographic impact for the state. It was noted jobs associated with the credit were concentrated mainly in the professional services industry and did not result in local displacement because research and development activities generally do not take business or money away from existing employers. The credit's impact on the state's gross domestic product was about $80 million per year with the state receiving about $213 million in revenue as a result of the credit over a 20-year period. It was anticipated the state would expend $66 million for the direct cost of the credit and $182 million in indirect costs as a result of maintaining an increased state population over the same 20-year period. The net result was the state having $30 million less than it would have had if the credit had not been provided. It was noted the credit is a net liability in terms of the state's budget but has a positive impact on the state's economy.

The committee also received testimony in favor of retaining the credit from a representative of Basin Electric Power Cooperative. The testimony indicated the cooperative averaged 529 employees allocating work time to research and development activities from 2014 through 2016. The main research and development activities undertaken by the cooperative include the development of new products, new methods, and processes to comply with environmental regulations and safer ways to produce existing products. The cooperative had accumulated $10.3 million in credits, had carried forward $8.7 million in unused credits, and has had $1.6 million in credits expire. The cooperative was not able to use all the earned credits because the cooperative is a capital-intensive company with large depreciation deductions resulting in net operating losses. The testimony explained how the credit operates in other states and the committee received suggested ways North Dakota's credit could be enhanced. Suggested enhancements included allowing the credit to be applied against withholding or other taxes, increasing the carryforward period for unused credits, allowing a portion of the credits to be refunded, and improving the disclosure of information related to the credit. The committee did not receive testimony in opposition to retaining the credit. The committee did not recommend any legislation to eliminate or modify the credit.

## DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE RESEARCH EXPENSE TAX CREDIT

Data pertaining to the following items will need to be collected to effectively analyze the incentive:

1. The number of claimants;
2. The fiscal impact of the incentive;
3. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the incentive;
4. Negative impacts created as a result of the incentive; and
5. Benefits that flow to out-of-state concerns resulting from the incentive.

Testimony will need to be solicited from the following parties to effectively analyze the incentive:

1. The Department of Commerce;
2. The Tax Department; and
3. The North Dakota Economic Development Foundation.